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Sulphur Springs Valley Electric Cooperative, Inc.

A Touchstone Energy® Cooperative

311 E. Wilcox, Sierra Vista AZ 85635

Arizona Corporation Commission
DOCKETED
DEC 29 2014
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AZ CORP COMMISSION
DOCKET CONTROL
2014 DEC 29 P 12: 36
RECEIVED

Arizona Corporation Commission
Docket Control
1200 W. Washington
Phoenix, AZ 85007

December 19, 2014

REFERENCE DOCKET NO: E-01575A-12-0457

IN THE MATTER OF THE APPLICATION OF SULPHUR SPRINGS VALLEY ELECTRIC COOPERATIVE, INC., FOR AN ORDER APPROVING A COMPREHENSIVE CREDIT MANAGEMENT PROGRAM AND SUPERSEDING AND REPLACING CERTAIN CONDITIONS CONTAINED IN DECISION 72237 PERTAINING TO THE REFINANCING OF SSVEC'S EXISTING AND AUTHORIZED DEBT.

Dear Sir or Madam,

Please find the attached report, along with thirteen copies (13), as it pertains to the credit matter described above:

1. Standard & Poor's Credit Profile and Rating of "A-" for SSVEC, Inc., dated December 10, 2014.

If you have any questions, or if I may be of further assistance, please do not hesitate to contact me at the phone number shown below.

Respectfully,

Sara Bojorquez

ORIGINAL

Sara Bojorquez on behalf of Kirby Chapman, CFAO
Sulphur Springs Valley Electric Cooperative, Inc.
Phone: (520) 515-3495
Email: shofer@ssvec.com

CC: Kirby Chapman

STANDARD & POOR'S RATINGS SERVICES
McGRAW HILL FINANCIAL

One California Street, 31st Floor
San Francisco, CA 94111-5432
tel 415 371-5000
reference no.: 40417417

December 10, 2014

Sulphur Springs Valley Electric Cooperative
311 East Wilcox Drive
Sierra Vista, AZ 85635
Attention: Mr. Kirby Chapman, Chief Financial & Administrative Officer

Re: ***Issuer Credit Rating,***

Sulphur Springs Valley Electric Cooperative, Arizona

Dear Mr. Kirby Chapman:

Standard & Poor's Ratings Services ("Ratings Services") hereby affirms its rating of "A-" for the above-referenced issuer and stable outlook. A copy of the rationale supporting the rating and outlook is enclosed.

This letter constitutes Ratings Services' permission for you to disseminate the above rating to interested parties in accordance with applicable laws and regulations. However, permission for such dissemination (other than to professional advisors bound by appropriate confidentiality arrangements) will become effective only after we have released the rating on standardandpoors.com. Any dissemination on any Website by you or your agents shall include the full analysis for the rating, including any updates, where applicable.

To maintain the rating, Standard & Poor's must receive all relevant financial and other information, including notice of material changes to financial and other information provided to us and in relevant documents, as soon as such information is available. Relevant financial and other information includes, but is not limited to, information about direct bank loans and debt and debt-like instruments issued to, or entered into with, financial institutions, insurance companies and/or other entities, whether or not disclosure of such information would be required under S.E.C. Rule 15c2-12. You understand that Ratings Services relies on you and your agents and advisors for the accuracy, timeliness and completeness of the information submitted in connection with the rating and the continued flow of material information as part of the surveillance process. Please send all information via electronic delivery to pubfin_statelocalgovt@standardandpoors.com. If SEC rule 17g-5 is applicable, you may post such information on the appropriate website. For any information not available in electronic format or posted on the applicable website,

Please send hard copies to:

Standard & Poor's Ratings Services
Public Finance Department
55 Water Street

New York, NY 10041-0003

The rating is subject to the Terms and Conditions, if any, attached to the Engagement Letter applicable to the rating. In the absence of such Engagement Letter and Terms and Conditions, the rating is subject to the attached Terms and Conditions. The applicable Terms and Conditions are incorporated herein by reference.

Ratings Services is pleased to have the opportunity to provide its rating opinion. For more information please visit our website at www.standardandpoors.com. If you have any questions, please contact us. Thank you for choosing Ratings Services.

Sincerely yours,

Standard & Poor's

Standard & Poor's Ratings Services

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enclosure

STANDARD & POOR'S RATINGS SERVICES
McGRAW HILL FINANCIAL

Standard & Poor's Ratings Services
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STANDARD & POOR'S RATINGS SERVICES
McGRAW HILL FINANCIAL

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Summary:
Sulphur Springs Valley Electric Cooperative, Arizona; Rural Electric Coop

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Table Of Contents

Summary:

Sulphur Springs Valley Electric Cooperative, Arizona; Rural Electric Coop

Credit Profile		
Sulphur Springs Vy Elec Co-op ICR		
Long Term Rating	A-/Stable	Affirmed

Rationale

Standard & Poor's Ratings Services has affirmed its 'A-' issuer credit rating (ICR) on Sulphur Springs Valley Electric Cooperative Inc. (SSVEC), Ariz. The outlook is stable.

Willcox-based SSVEC is a distribution cooperative that relies on others to supply all of its customers' electricity needs. It is a member and one of six owners of its principal power supplier, Arizona Electric Power Cooperative (AEPCO), a generation and transmission (G&T) cooperative that provided 87% of SSVEC's customers' 2013 energy requirements. Its nearly 51,000 retail meters exhibit a low customer density of approximately 12 customers per line mile and the system's peak demand was only about 205 megawatts (MW) in 2011-2013. The cooperative's service territory covers parts of Cochise, Graham, Pima, and Santa Cruz counties. SSVEC also operates the transmission and distribution system serving Fort Huachuca, but does not supply the military base's electricity. The utility earns about half of its operating revenues from residential customers and the balance is nearly evenly split among its irrigation, commercial, and industrial customers.

The cooperative reported about $108 million of fiscal 2012 and 2013 (year-ended June 30) operating revenues and about $167 million of debt as of June 30, 2013. The utility's debt consists of National Rural Utilities Cooperative Finance Corp. (NRUCFC) and CoBank ACB loans. It plans to refinance its CoBank and NRUCFC obligations with short-term debt that it can retire with long-term capital market debt.

The rating reflects our views of the following credit strengths:

- In fiscal years 2010-2013, utility operations produced strong accrual coverage of direct debt of at least 1.5x and sound fixed-charge coverage of at least 1.2x. Fixed-charge coverage treats capacity charges paid to energy suppliers as debt service, rather than as an operating expense because we view capacity charges as funding the suppliers' recovery of their investments in generating capacity.
- In July 2014, the utility entered into an indenture that prescribes a threshold debt service coverage (DSC) ratio of 1.25x, which we view as sound. However, the indenture allows lower coverage in connection with certain prescribed acquisitions of power plants and service territory expansions.
- About half of the utility's energy sales are to residential customers that we associate with revenue-stream predictability. The balance of its sales is split almost evenly among small commercial, large commercial, and irrigation loads, without significant customer concentrations, which SSVEC's low load factor of 48% reflects.
- We believe the nearly 51,000 customers provide breadth and diversity to the revenue stream. However, beyond

customers in the city of Sierra Vista, the service area exhibits income levels about 20%-30% below the national average, which we view as having the potential to limit the cooperative's financial flexibility.

- A power cost adjustment mechanism enables this rate-regulated utility to recover changes in fuel costs and market power purchases from customers without filing a rate case before the Arizona Corporation Commission (ACC). However, management and the board have discretion in timing SSVEC's cost recovery and the board emphasizes maintaining stable retail rates, which we view as having the potential to erode cash flows.
- In March, the ACC fully granted the utility's request for a 4.5% rate increase. The rate proceeding represented the first use of the ACC's expedited docket for cooperative utilities.
- The ACC adds the costs of complying with Arizona's renewable energy mandates to retail rates to assure cost recovery.
- Liquidity facilities compensate for nominal unrestricted cash and investments.
- A proposed September U.S. Environmental Protection Agency (EPA) ruling preliminarily accepts AEPCO's proposal to remediate the Apache Station's emissions to meet regional haze requirements by the end of 2017. The proposal provides for operating one of the station's two coal units as a simple cycle natural gas unit, installing low nitrous oxide burners on both units, and installing selective non-catalytic reduction technology on the remaining coal unit. If the EPA grants final approval, this will be a significant development for SSVEC, which pays a pro rata share of AEPCO costs. This plan's $27 million cost is less than one-sixth of the cost of the plan that EPA originally advanced.

We believe these factors temper the cooperative's strengths:

- The EPA's recently proposed carbon regulations target a 52% carbon emissions reduction for Arizona relative to 2012, which might have significant cost and operational implications for SSVEC because of its financial commitments to AECPCO, which has two coal assets anchoring its generation. Although SSVEC can make market purchases from suppliers with more favorable variable costs, its fixed-cost obligations to AEPCO do not abate.
- The EPA's mercury rules also expose AEPCO and SSVEC to potentially higher compliance costs. However, AEPCO projects mercury rule compliance costs at less than $4 million.
- AEPCO's two 175 MW coal units at the Apache Station are more than 30 years old and many market resources eclipse their efficiency and economics.
- Compared with cooperative utilities with autonomous ratemaking authority, state rate regulation of SSVEC and its exposure to adversarial rate proceedings could expose the cooperative's financial performance to delayed rate relief or cost disallowances. However, we view the commission's recent implementation of an abbreviated rate proceeding for cooperative utilities as mitigating the utility's exposure to regulatory lag. The utility used this procedure and received a 4.5% rate increase in March.
- The ACC's order that established the procedures for streamlining rate cases caps each rate case's increase at 6% of prevailing base rates and limits the number of expedited proceedings to five in 15 years.
- Costly power supply commitments to its principal supplier, AEPCO, and low customer density contribute to average residential retail rates that the Energy Information Administration reports at levels nearly 25% above the state's average residential rate, which we believe could impair ratemaking flexibility.
- Coal resources accounted for about 99% of AEPCO's 2013 electricity generation and 82% of the energy it supplied to its members, which expose the utility and its lenders to the effects of potentially higher costs as the EPA pursues more stringent power plant emissions constraints. Purchases from hydroelectric and other resources moderately temper AEPCO's coal concentration.
- We view the utility's debt-to-capitalization ratio of 67% as high for a distribution utility.

Since 2008, the utility has been a partial requirements member of AEPCO. In 2008, SSVEC and two other of AEPCO's six members migrated from full requirements to partial requirements contracts. The three partial requirements customers have fixed entitlements to shares of AEPCO's resources' output and are responsible for a corresponding portion of the utility's debt obligations. They purchase from other suppliers their customers' electricity needs beyond the fixed shares. This arrangement insulates AEPCO's smallest customers from the costs of the additional generation needs of the larger, faster growing customers. The three largest members represent about 90% of AEPCO obligations and the other three, about 10%. In 2013, SSVEC purchased about 87% of its customers' electricity needs from AEPCO and the balance from other suppliers. Market purchases tend to be most prevalent during the summer to meet its retail customers' peak demand requirements. The cooperative is responsible for about 32% of AEPCO's debt service obligations.

Outlook

The stable outlook reflects our assessment of sound coverage of direct debt and fixed off-balance-sheet obligations to energy suppliers. The utility's significantly residential customer base and the absence of customer concentration also contribute to stability. Although the utility exhibits sound quantitative attributes, AEPCO's exposure to evolving EPA mandates and their potentially substantial costs, creates financial uncertainty for not only AEPCO, but also SSVEC. Furthermore, the service area's demographics might limit financial flexibility. Consequently, Standard & Poor's believes that these characteristics constrain the rating's upward potential.

We could lower the rating during our two-year outlook horizon if the costs of complying with EPA mandates erode financial results, if the service area's income levels are an impediment to rate adjustments, or the utility does not recover costs through its pass-through mechanism in a timely manner.

Related Criteria And Research

Related Criteria

- USPF Criteria: Applying Key Rating Factors To U.S. Cooperative Utilities, Nov. 21, 2007

Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column.